

COMMONWEALTH OF KENTUCKY
FRANKLIN CIRCUIT COURT
DIVISION I
CIVIL ACTION NO. 05-CI-00459

COMMONWEALTH OF KENTUCKY,
OFFICE OF THE ATTORNEY GENERAL
Ex rel. Gregory D. Stumbo in his official
Capacity as Attorney General of the
Commonwealth of Kentucky

PETITIONER

v.

MEMORANDUM IN SUPPORT OF
MOTION FOR SUMMARY JUDGMENT

BOARD OF DIRECTORS FOR THE
COMMONWEALTH POSTSECONDARY
EDUCATION PREPAID TUITION
TRUST FUND, et al.

RESPONDENTS

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INTRODUCTION

This case arises from the operation of the current biennial budget, HB 267, which went into effect July, 2005. The budget orders the Respondents to take Thirteen Million, Seven Hundred Thousand and One Hundred (\$13,700,100.00) Dollars from the Commonwealth Postsecondary Prepaid Tuition Trust Fund (“KAPT fund”) and place it in the General Fund. It also prohibits transfers from the unclaimed property fund or the General Fund to the KAPT fund and repeals KRS 393.015, the statute which pledges 75% of the abandoned property held by the Commonwealth as a reserve for the KAPT fund (sometimes referenced as the “reserve fund”).

The KAPT fund was created to receive payments on prepaid tuition contracts (“KAPT contracts”) and income on investment of those funds. It also holds money transferred from the reserve fund on those occasions when the KAPT Board has

determined a transfer is necessary to meet the contractual obligations of the KAPT program. The manner in which the KAPT Board invests the contract payments and the transfers from the reserve fund is dictated by statute and the KAPT contracts. Neither allows for the Commonwealth to take money from the KAPT Fund for its own use or bar use of the reserve fund pledged to guarantee the contracts. By repealing the statute which authorizes the reserve fund and further by directing KHEAA to take money from the KAPT Fund and place it in the General Fund, HB 267 unconstitutionally seizes private property from the citizens of the Commonwealth in violation of *Ky. Const. Sections 2, 13 and 51* and further impairs the KAPT contracts between the citizens and the Commonwealth in violation of *Ky. Const. Section 19*.

STATEMENT OF THE CASE

Legislative History of the KAPT Program¹

The idea of creating Kentucky's Affordable Prepaid Tuition (KAPT) was born in the summer of 1999. The goal was simple, to create a program that made it easier for families to afford college by guaranteeing the cost of tomorrow's tuition at today's lower prices. KAPT's creators were advised there must be some fund that served as a guarantee. Similar prepaid tuition plans that did not have a guarantee were largely unsuccessful. The purchasers would only choose to invest in such a plan over other investments in the marketplace, which may potentially could have a greater upside, if security beyond the value of the investments were provided. Pre-paid tuition programs are designed for risk-adverse investors; families who prefer certainty over a risky market.

¹ Within the section styled "Legislative History of the KAPT Program", all factual references, except those otherwise specifically documented, are based upon the affidavit of Treasurer Miller, attached hereto as Exhibit 1.

KAPT's creators were presented with two options. One was backing up KAPT's investments with the full faith and credit of the Commonwealth. However, unlike states which had such a guarantee, Constitutional amendment would have been necessary, so this option was rejected as unworkable. A few other states, including Mississippi, backed up their programs with the state's unclaimed property fund. That is, if investments did not keep pace with tuition inflation, money could be withdrawn from the unclaimed property fund to defray the unfunded liability. This became the model for the KAPT legislation.

A few amendments were made during the legislative process regarding the plan's governance, but the major features of the plan, including the unclaimed property guarantee, remained. The KAPT bill passed unanimously in both the House and Senate, and Governor Patton signed the bill into law in April 2000.

The State Treasurer was appointed to set up the program. KAPT was launched in October 2001 and enrolment was opened to the citizens of Kentucky. Demand for KAPT contracts was immediate and strong. In 2003 the state Senate passed a budget resolution which included a provision to shut down KAPT to new enrollment. The Senate budget would have also forced out of the program every participant that had not paid their entire KAPT obligation in one lump sum. The plan to force participants out of the program failed, but a moratorium was placed upon new enrollments for the 2004 fiscal year.

After that legislative session, the State Treasurer Jonathan Miller met with legislators who had expressed their concern about using unclaimed property to backup the KAPT fund. This was of concern because the cash in the abandoned property fund was being used by the General Assembly for other purposes. With the support of the

Patton and later the Fletcher Administration, Controller Ed Ross and Acting Budget Director Mary Lassiter designated a separate off-budget fund consisting of unclaimed property stocks and bonds to serve as a “KAPT Reserve.” These stocks and bonds had never even been accounted for in the General Fund and were under the complete control of the State Treasury. (See Jo Carole Ellis Deposition, Exhibit 11, attached hereto as Exhibit 2) The amount was sufficient to handle potential KAPT deficits if used wisely.

In addition, Finance and Administration Cabinet officials approved of a plan for the KAPT Board to open the program to new enrollment and charge premiums of 7.5% on new contracts to ensure the financial stability of the program in the future. This had been attempted in several other states and had been a successful way of reducing actuarial deficits. It was made part of the House budget bill, but no budget passed that year. When the enrollment moratorium in the 2003/2004 biennial budget expired in July, 2004, the KAPT board voted unanimously to reopen the KAPT program with premiums on new contracts. KAPT was reopened that fall, and nearly 2000 more families signed up, for a total of more than 8900 since the program began in 2001.

In late 2004, the KAPT Board received an actuarial report which indicated that because of extraordinary tuition increases over the past three years, KAPT was running a \$13.7 million actuarial deficit. The KAPT Board members voted, again unanimously, to transfer an equal amount from the reserve fund to the KAPT Fund. (See Jo Carole Ellis Deposition, Exhibit 9) Treasurer Miller met with leaders in the legislature, Budget Director Brad Cowgill, Deputy Finance Secretary John Farris and Controller Ed Ross, and they all agreed with the transfer from the KAPT reserve. Over the course of the next two weeks the transfer was completed, with facilitation by Controller Ross and the staffs

of Treasury, Finance and the Budget Director's office. KAPT's investment manager, Fifth/Third Bank, used the money to purchase a diverse portfolio of equities and bonds.

When the General Assembly returned in 2005, and with no hearing, no study, or even an inquiry into the program, the Senate passed a budget which called for a suspension in KAPT enrollment, and ordered the KAPT Board to "return" \$13.7 million to the General Fund. Presumably, this \$13.7 million represented the same money transferred to the KAPT Fund from the reserve fund by the KAPT Board. In the conference committee, the idea of liquidating the KAPT fund and refunding participants original investments was also discussed. The House again refused to liquidate the program, but the final budget bill retained the seizure \$13.7 million and permanently repealed the statute that provides the unclaimed property guarantee for the program, KRS 393.015.

In separate legislation, House Bill 184, the General Assembly clarified existing statutory language to make clear that all of the money in the KAPT Fund "shall be deemed to be trust funds to be held and applied solely for payment to qualified beneficiaries." Also repealed the language in KRS 164A.701(4) which designated the assets of the KAPT fund as "public funds" for purposes of investment.

If the KAPT fund is compelled to pay the General Fund \$13.7 million, the program will have a shortfall of \$54 million by 2025, and will run out of money in 2020, based upon an actuarial analysis performed in the spring of 2005. In addition, a more recent analysis, performed as of the close of fiscal 2005 projects a deficit of about \$7 million in addition to the \$13.7 million which the current budget would take for the General Fund. (See Jo Carole Ellis Deposition, Exhibits 1 & 4)

Relevant Budget Language

Three specific sections of the 2005/2006 biennial budget are at issue. The first takes \$13.7 million from the KAPT fund and places it in the General Fund. The second orders that no money from the General Fund or from abandoned property shall be available to support the KAPT Fund. The third repeals KRS 393.015, the statute which provides for the reserve fund. The exact language is as follows:

HB 267 at page 122 states:

(6) Kentucky's Affordable Prepaid Tuition (KAPT) transfer:

Notwithstanding KRS 164A.701 to 164.704 and 393.015, the Board of Directors of the Kentucky Higher Education Assistance Authority shall return the \$13,700,100 transferred to the Kentucky Affordable Prepaid Tuition Program from the KAPT Reserve Fund, by action of the KAPT Board of Directors on December 1, 2004, to the General Fund in fiscal year 2004-2005. The Board shall report the action to the Interim Joint Committee on Appropriations and Revenue no later than June 30, 2005. Further transfers from the KAPT Reserve Fund to the KAPT program are prohibited.

HB 267 at page 305 states:

No general fund moneys or abandoned property funds shall be available for the support of the Commonwealth postsecondary education prepaid tuition trust fund.

HB 267 states at page 307:

Section 2. The following KRS section is repealed: 393.015 Use of abandoned property funds to support Commonwealth postsecondary education prepaid tuition trust fund.

Actuarial Analysis and Recommendation

Following the establishment of the KAPT program in 2001, the KAPT Board obtained annual actuarial analysis of the KAPT Fund as required by KRS 164A.704(7). Initially, these were performed by Milliman, USA. In both 2002 and 2003, deficits of

roughly \$3,000,000 and \$11,000,000, respectively, were identified. However, no recommendation was made to the KAPT Board to transfer money from the reserve fund to the KAPT Fund. Instead, the actuary determined the soundness of the KAPT Fund by comparing the deficits to the value of the reserve fund, 75% of the abandoned property fund, as based upon the anticipated rate at which property escheats to the Commonwealth. (See Jo Carole Ellis Deposition, Exhibit 12)

For the 2004 analysis, the KAPT Board chose a new actuary, Robert Crompton. Mr. Crompton again found the KAPT Fund to be in deficit. However, rather than simply analyzing the continued solvency of the KAPT Fund by measuring the deficit against the static increases in the size of the abandoned property fund, he recommended the KAPT Board address the deficit by transferring money from the abandoned property fund to the KAPT Fund, under KRS 393.015. In his sworn statement attached hereto as Exhibit 3, Mr. Crompton explained the reasons for recommending the transfer as follows:

. . . I recommended that there be a transfer of \$13,700,051.00 from the Unclaimed Property Fund to the KAPT Fund. The reason for making this recommendation is that the funds once transferred - - the monies once transferred into the KAPT Fund would then be invested in such a way that they would grow in a manner anticipated to match the growth of the deficit that would otherwise occur. Leaving the monies in the Unclaimed Property Fund would not include the investment of these monies in such a way as to grow in the same pattern that the deficit was projected to grow.

Crompton Statement, page 12.

In short, making the transfer from the abandoned property fund to the KAPT Fund was fiscally responsible. It minimized the cost of erasing the deficit which would have ballooned over 400% had they waited until there had been an actual default, thereby preserving the abandoned property assets in the reserve fund, and increasing the

likelihood the reserve fund will be capable of covering deficits which may develop in the future. Mr. Crompton explained this phenomenon:

The deficit of the KAPT Program is, in essence, a financial asset and because of that it grows with interest or with investment return, if you will; that is, it's not a static item. If it's a deficit, it's going to become a larger deficit. If it's a surplus, it's going to become a larger surplus over time and it does that because, as I mentioned, it's a financial asset. It accretes with investment income. Because it is a growing item, it's important that any offsetting assets be invested in such a way that they accrete in the same way as this deficit.

The monies in the Unclaimed Property Fund, to my understanding, are not invested or at least not invested in such a way as to accrete at the same rate as the deficit of the KAPT Program. Therefore, it was important that these monies be transferred into the KAPT Fund so that not only would they offset the deficit at the time of the transfer but they would continue to offset the deficit into the future. If these monies had been left in the Unclaimed Property Fund the deficit would continue to accrete but the monies, the \$13.7 million offset would not accrete and there would no longer be such an one-to-one offset.

Crompton Statement, page 14.

The Abandoned Property Fund

The “abandoned property fund” often referred to as the “unclaimed property fund” is the “fund in which moneys are placed” when they are turned over to the Treasury by operation of KRS Chapter 393; the “Escheats Act”. KRS 393.010(1)(i). The Escheats Act provides for various type of property to be turned over to the State Treasury when it has not been claimed by the owner for a specified period of time. At that point it is presumed to be abandoned and the Commonwealth takes the property subject to the equitable claims of the owner. KRS 393.020. Such equitable claims include the right to return of the property until such time as the Commonwealth institutes a suit to have the property found to be “actually abandoned”, disposing of the equitable claim. *Commonwealth, by Geary v. Johnson*, 668 S.W.2d 569 (Ky., App.1984). Since the

Unclaimed Property Program was placed under the authority of the Kentucky State Treasurer in 1994, no suit has been filed by the Commonwealth to have property found to be “actually abandoned”.

Abandoned property turned over to the Treasury can generally be categorized as cash, commercial paper such as stocks and bonds, or tangible property. The Finance and Administration Cabinet takes a portion of the property which is cash and uses it as a “revenue stream” for the General Fund. However, the money that goes to the General Fund remains on the books as an asset of the unclaimed property account, which is reflected as a program code T000 account within the state accounting system. Currently the state accounting system reflects a balance in the unclaimed property account of \$118,959,610.28.

However, property which is turned over to the Treasury as stock is not accounted for in the T000 account in the state accounting system. Instead, stock which comes into the Treasury is held in an account with Morgan, Keegan & Company, Inc. and is currently valued at \$35,976,901. It is generally the policy of the Treasury to hold stock at least 3 years before it is sold pursuant to KRS 393.125. It was stock from this account which was sold to cover the \$13.7 million deficit in the KAPT program so that the operating funds of the Commonwealth would not be affected. (Affidavit of Eugene Harrell, attached hereto as exhibit 4)

The Executive director of the KAPT program testified as to the manner the Finance and Administration Cabinet designated the assets to be used in the reserve fund for the KAPT program as follows:

Q. . . . I was interested in the figures because it shows a total balance of Kentucky unclaimed property of seventy million, nine hundred twenty-eight thousand and some odd dollars; is that right?

A. Yes.

Q. But it shows balance of Kentucky unclaimed property reserve to settle obligations of the Kentucky Affordable Prepaid Tuition Program as of June 30 '04 of twenty-eight million, three hundred and thirty-nine thousand some odd dollars; is that right?

A. Yes.

Deposition of Jo Carole Ellis, page 67.

Q. So what accounts for that \$28,339,677?

A. It's my understanding that's the value of the stocks held by the unclaimed property, the stock portfolio.

Q. So was it agreed by and between KHEAA or KAPT and the controller, Mr. Ross, that those funds would be specifically set aside for settling or as a reserve for obligations of the KAPT program?

A. I believe that was agreed upon before KAPT was transferred to KHEAA.

Q. And do you know why the controller agreed specifically that those funds which were held as stock holdings were to be used primarily to settle the obligations of the KAPT program?

A. It's my understanding that because the cash that comes into unclaimed property fund is used each year by the general fund, that they determined they would need to set aside the stocks which had not been used.

Q. So this money could be taken then without affecting the operating funds used by the legislature; is that right?

A. That's correct.

Q. And is that where the funds came from for this 13.7 million dollars?

A. That's my understanding, yes.

Deposition of Jo Carole Ellis, at page 68.

Use of the Abandoned Property Fund as a reserve for the KAPT Fund

The legislation which created the Commonwealth Post Secondary Education Prepaid Tuition Trust Fund, KRS 164A.700-709, also amended the Escheats Act by enacting KRS 393.015. The statute pledged 75% of the abandoned property funds “for support” of the KAPT Fund. It further authorized transfers from the “abandoned property fund” to the KAPT fund to meet any “unfunded liability as determined by the Board.”

Consequently, the KAPT contracts were written in a manner which provided the owner no source for payment for the obligations of the KAPT Fund other than from the assets of the KAPT fund. Further, by the terms of the contract the purchasers waived any rights they might have had against the Commonwealth in the event of default. The pertinent contractual terms state as follows:

Article IX, 9.03: No Commonwealth Liability. The purchaser, on behalf of himself, the qualified beneficiary, and their heirs and successors, understands and acknowledges that (a) only assets of the fund are available to guarantee the contractual obligations to the purchaser and qualified beneficiary, (b) this agreement does not obligate the general revenue or any other fund of the Commonwealth, nor does it obligate KHEAA or any public institution, (c) this agreement shall not be considered a debt or liability of the Commonwealth or KHEAA and neither the credit nor the taxing power of the Commonwealth are pledged to paying benefits hereunder, and (d) this agreement does not constitute a pledge of the full faith and credit of the Commonwealth. Under KRS 393.015, 75% of the balance of the Abandoned Property Fund administered by the Kentucky State Treasurer is available to meet any unfunded liability of the fund, as may be determined by the Board.

Article X, 10.07: Limited Liability. Any claim by the purchaser or the qualified beneficiary pursuant to this agreement shall be made solely against the assets of the fund. No recourse shall be had by the purchaser, the qualified beneficiary, or any other party against the Board, KAPT, KHEAA, their officers, agents, or employees or against the

Commonwealth in connection with any right or obligation arising out of this agreement.

The KAPT Board is vested with a responsibility to the purchaser to ensure the reserve fund is utilized in such a manner which protects the KAPT Fund from default, since in the event of default the purchasers have no recourse. See also KRS 164A.705(2) as amended. Not even against the reserve fund. The Boards duties and responsibilities are delineated in KRS 164A.704 (7). The following is language from HB 184 which provides a look at the statute both before and after the amendment which went into affect July, 2005:

- (7) ~~Have the~~*Obtain appropriate* ~~actuarial soundness of~~
~~the~~*assistance to establish, maintain, and certify a* ~~fund evaluated by a~~
~~nationally recognized independent actuary on an annual basis~~*sufficient to*
~~defray the obligation of the fund, annually evaluate or cause to be~~
~~evaluated, the actuarial soundness of the fund,~~*]* ~~and determine prior to~~
~~each academic year;~~
- (a) The amount of prepaid tuition for each tuition plan and for each eligible educational institution for specific academic years, the corresponding value;
and
- (b) Whether additional assets are necessary to defray the obligations of the fund. If the assets of the fund are insufficient to ensure the actuarial soundness of the fund, as reported by the actuary, the board shall adjust the price of subsequent purchases of prepaid tuition contracts to the extent necessary to restore the actuarial soundness of the fund. The board may suspend the sale of prepaid tuition contracts until the next annual actuarial evaluation is completed if the board determines the action is needed to restore the actuarial soundness of the fund. During a suspension of sales of contracts, the board and Tuition Account Program Office shall continue to service existing contract accounts and meet all obligations under existing prepaid tuition contracts;

HB 184 at p. 14.

The duty of the KAPT Board at the time it voted to transfer money from the reserve fund to the KAPT fund was to “establish, maintain and certify a fund sufficient to defray the obligation of the fund.” When viewed in light of the waivers made by the

purchasers of the KAPT contracts, the importance of the KAPT Board carrying out this duty cannot be overstated. Should the KAPT Board fail in its duty the purchasers and beneficiaries will suffer a total loss in the event of default. Further, the mechanism proposed by the amendments to KRS 164A.704 (7), charging premiums on future contracts, while helpful in addressing deficits, does not offer the same security as does the guarantee of an identifiable asset like the abandoned property fund.

In his statement, Mr. Crompton addressed the affect removing the reserve fund will have on the individual investments in KAPT as well as the short comings of attempting to address deficits solely through charging premiums on future contracts. His thoughts are sufficiently pertinent to justify their reproduction herein at length; and follow:

Currently, the program without the backing of the Unclaimed Property Fund is in a deficit. Once again, the meaning of the deficit is that the program will run out of money before all benefits can be paid. Therefore, there will be some participants in the program who will not receive their benefits if there is a deficit. And the availability of Unclaimed Property Fund is important because it allows the program to pay out all of the liabilities which it has undertaken with the proviso that, yes, I understand that there is no guarantee by the state of these benefits.

Q. Would the net effect of removing that reserve from the equation increase the risk of the investment made by the contract holders, the owners of the individual KAPT contracts?

A. It would certainly increase the riskiness to the contract holders because it would make the likelihood of their not getting anything for their money more likely. And, in fact, I can state further than that; that if there is a deficit, then, I would expect some of the contract holders not to receive any benefit.

Statement of Robert B. Crompton, page 17.

Q. Has there developed, at least in your experience, a correlation between the size of the premium or surcharge and the marketability of the contracts?

A. In a general sense, yes. The general sense is that the higher the surcharge, the less marketable that the contracts are. This is what I was alluding to in Pennsylvania where for contracts sold for the Pennsylvania State University which had a surcharge of 12.9% or thereabouts, the number of contracts sold for Pennsylvania State University were smaller for 2004/2005 than they were for 2003/2004 in which year, the earlier year, the surcharge was 9%.

Q. Are there competing investment vehicles with these prepaid tuition plans which investors use to reach similar goals?

A. Yes, there are.

Q. What type of plans are out there?

A. There are straight mutual funds. In addition, there are what are called Section 529 investment programs which are tax-advantaged mutual funds enabled under Section 529 of the Internal Revenue Code that provide certain tax benefits to people who save for college using these programs.

Q. So, there is an actual competitive market in which this KAPT Program, in particular, in which it competes for investment dollars, is that correct?

A. Yes.

Q. Are there benefits to investing in this type of vehicle as opposed to the other competing investment vehicles?

A. Yes, there are. The KAPT Program is the only program in the State of Kentucky that offers to pay tuition regardless of whether tuition is high or low. The competing programs offer an accumulation of funds but don't offer to pay tuition, per se.

Q. And what does that do for the investor?

A. It reduces the risk to the investor by assuring him that the tuition will be paid.

Q. Would this be normally considered an investment that someone who is risk adverse would seek out?

A. Yes.

Q. Am I correct in understanding that if the reserve fund is taken away, that would change the equation regarding the risk which was being assumed by each of the contract owners?

A. That is correct. If the deficit continues, then, there will be at least some contract owners who will not receive their benefits.

Q. It will cease to be a low-risk investment, is that correct?

A. Yes.

Q. And for people whose contracts do not anticipate entry into college of their child until a number of years down the road, it could, in fact, become a high-risk investment, is that correct?

A. Yes, it is.

Statement of Robert B. Crompton, page 35.

Q. For investments sold within an open market, would such alteration of the risk materially affect the value of the investment?

A. Yes, it would.

Q. These are not sold in open market, however, is that correct?

A. True.

Q. The only option for a person who thought they had a low-risk investment and now have a high-risk investment would be to cancel their contract, is that correct?

A. If they wanted to avoid the risk of receiving nothing, yes.

Q. And if they take that action, will they receive in return all of the money they have invested?

A. They will receive all of the money paid into the contract minus processing fee.

Q. Will they receive any anticipated increases in the value of that money that they could have gotten from other vehicles which they forewent when they purchased these contracts?

A. No, they will not.

Q. So, they will suffer a loss of both the processing fee and any money they could have made in a competing investment is that correct?

A. That is correct.

Statement of Robert B. Crompton, page 37.

The Contract Purchasers do not Own a Share of the KAPT Fund

The KAPT contracts give purchasers a set of rights to payment of future college tuition for the designated beneficiary if the conditions and prerequisites in the contract are met. If the purchaser chooses to cancel the contract before the beneficiary enters college then the money which has been paid into the program will be returned, minus administrative fees. However, the “value” of the contract is not returned. The entire value of the contract can only be enjoyed by the beneficiary when the KAPT Fund pays his or her tuition. (See Master Agreement generally, Exhibit F to the Amended Petition)

The “value” of a KAPT contract is defined as follows:

Article II, 2.18 Value of Prepaid Tuition Account: means the amount which the fund is obligated to pay for tuition for an academic period based on full payment of the purchaser’s tuition plan; except, under a tuition plan for private colleges and universities, tuition shall be calculated based upon the same percentage that University of Kentucky tuition is increased from the year the agreement is purchased to the year of payment. . . .

Annual Statements are provided to the purchasers by the KAPT program, and purchasers can also view their accounts on line at www.getkapt.com. These statements show the purchaser how much they have paid into the program, the benefits they have purchased in credit hours, and, if there remains a balance due on the KAPT contract, the amount of the balance due. It does not show appreciation on the investment, nor does it

track the “value” of the contract in relation to the tuition which is currently charged by the University of Kentucky. (Deposition of Jo Carol Ellis, at p. 31-32.)

This issue is addressed due to an apparent misunderstanding on the part of the Finance and Administration Cabinet that purchasers own a “share” of the KAPT Fund which is accounted for by the KAPT program on an annual basis. (See Respondent’s answer to interrogatory No. 14.) The Finance Cabinet’s Answers to Interrogatories and Request for Admissions are attached as Exhibit 5.

Mr. Crompton addressed the Cabinets assertion on this issue as follows:

The value of the prepaid tuition account is determined totally independently of the amount that a contract owner has paid into the account and, therefore, it is totally independent of what an account owner may see as his “account” on the Internet. The value of the prepaid tuition contract in Paragraph 2.18 of the master agreement is based strictly on the then current tuition at the University of Kentucky and is not determined in any way, form or fashion in relation to the amount of money paid by an account owner.

Q. Well, then, let me ask you this. Is it related to any money they’ve paid in plus whatever increase in value their theoretical share of the total program fund that has occurred since they bought into the contract?

A. No. It is completely uncoupled from both the amount paid in and from any investment results in the KAPT Fund itself.

Q. So, if the KAPT Fund does very well, they don’t have a bigger share of it. If it does very poorly, they don’t have a smaller share of it. Is that correct to say?

A. Yes, it is. The results from the KAPT Fund with respect to investment results have no effect on the value of a prepaid tuition contract as defined in master agreement, Paragraph 2.18.

Statement of Robert B. Crompton, page 32.

Investment of the \$13.7 million transferred to the KAPT Fund²

The transfer from the abandoned property fund to the KAPT Fund was completed through three separate wire transactions on December 7, 10 and 13, 2004. These were received by Fifth Third Bank, which administers the KAPT Fund, on December 9, 15 and 17, 2004. (Long statement, p. 8.) These transfers were initially placed in the “Liquid Asset Management” (sometimes “LAM”) account. This is the account Fifth Third maintains to take in cash which is to be invested in the KAPT Fund pursuant to the investment plan set by the KAPT Board. (Long statement, p. 9-10.) When the cash in the LAM exceeds \$1 million it is disbursed into the investment funds in KAPT’s name. (Long Statement, p. 10.) Because of the size of the wire transfers disbursements were made immediately on December 14 and December 17. (Long statement, p. 14-17.) At that point the wire transfers had been thoroughly commingled with the investments of the contract purchasers. (Long statement, p.17.) Since December 17, 2004, there has been no way to trace the transfers from the abandoned property fund. Mr. Long explained why:

Q. Once these assets have been purchased with money out of the liquid assessment management account, - - -

A. Uh-huh (Affirmative).

Q. - - - is there any way to continue to track which assets were purchased with outside funding from state wires as opposed to cash received from contracts and continuing payments?

A. No. We’ve never really been charged with any sort of bookkeeping from that standpoint. So, money is just commingled with other money and moved around.

² The Statement of Clinton Long, the investment consultant with Fifth Third Bank who has managed the KAPT Fund since its inception, is attached as Exhibit 6. Review of his complete statement is encouraged if the court has any questions concerning how the KAPT Fund operates.

Q. And once, then, it gets into these accounts, does it just stay there in those accounts or are they subject to any type of reallocation?

A. No, there is reallocation that goes on to make sure that we stay in compliance with the investment policy statement.

Statement of Clinton Long, page 11.

Q. So, even if you could, for example, trace the money from the wire transfers into those accounts, it would have been subject to either growth or, conversely, loss which would then have been either moved around to other funds or had to be then again made up by more funds coming out of the Liquid Assessment Management account?

A. That's correct, because there are monies moving from the liquid assessment management account relatively frequently.

Statement of Clinton Long, page 12.

Q. And those were invested, again, in what accounts on the 14th and what accounts on the 17th?

A. On the 14th, it was in the fixed income account, the dividend growth and the international. On the 17th, the transfer went to the large cap value.

Q. And as far as we know, then, from this statement, that's the last point at which any tracing of the money from the state wires would have ended, any potential for that type of tracing would have ended?

A. Yes. Yes. That's correct, because the total transfer amount works out to about sixteen and a half million dollars and, you know, obviously we're talking about not even \$14 million; so, essentially, it's already ended at that point.

Statement of Clinton Long, page 17.

Mr. Long also addressed the ability of the KAPT Fund to pay to the General Fund \$13.7 million. Under no circumstances would he be able to do so using the cash or the investments purchased by the transfers from the reserve fund. He stated:

Q. And in order to carry out that transaction, what would you have to do with the assets of this account?

A. At this point, I would have to check. I don't know that we have \$14 million available in cash. So, there would probably have to be some sales of some securities in order to raise the cash amount.

Q. If you had it in cash - - -

A. Un-huh (Affirmative).

Q. - - - now, would that be cash that was received from the state wires?

A. No. Absolutely no. No. If we had it in cash at this point, it would basically be any pooled cash in the different investment funds that has not been reinvested and any cash that we're holding from incoming contracts.

Q. If you didn't have the cash, you would have to sell assets, is that correct?

A. That's correct.

Q. Would it be possible to trace the money from the wires to any of the assets that you would be selling in order to meet the obligation of paying the state \$13.7 million?

A. You're saying to go back and trace down the state's \$13.7 million and sell those assets?

MR. JONES: Yes.

A. No.

Q. Again - - and I know we've gone over it twice - - but why?

A. Reason being that the monies are originally commingled in the liquid asset management account. From that point, they are broken out into the different investment funds, again, with money coming in from the different sources that money comes into this account. And, again, we were never charged with keeping it separate, so, we didn't. So, it has been kind of mixed in with all the other money and it would basically be impossible to trace back down at this point.

Statement of Clinton Long, page 18.

Therefore, compliance with the budget will compel the KAPT program to liquidate assets which are comprised primarily of private investments made by the citizens of Kentucky to the direct detriment of those citizens. It is now impossible to “return” the \$13,700,100 transferred to the Kentucky Affordable Prepaid Tuition Program” as called for by the budget, even if one assumes it was ever accounted for within the budget to begin with.

ARGUMENT

I. Taking \$13.7 million from the KAPT Fund and removing the Contractual Guarantee for KAPT Contracts provided by KRS 393.015 impairs the Commonwealth’s obligation on those Contracts in violation of Section 19 of the Kentucky Constitution.

Since the inception of the KAPT program in 2000, 8,901 KAPT contracts have been sold to the citizens of the Commonwealth of Kentucky who relied upon the contract terms as well as the existing statutes when choosing to place their investment in their child’s education with the KAPT program. KAPT contracts are not guaranteed by the full faith and credit of the Commonwealth of Kentucky, and the purchasers have waived all legal recourse against the Commonwealth. It is indeed hard to imagine circumstances tailored any more perfectly to illustrate the need for the protections afforded by Section 19 of the Kentucky Constitution.

Section 19(1) of the Kentucky Constitution provides:

No ex post facto law, nor any law impairing the obligation of contracts, shall be executed.

The protections of *Ky. Const. Section 19* extend to contracts of the state or subdivisions thereof and a private person. *City of Covington v. Sanitation District No. 1*, 301 S.W.2d 885 (Ky., 1957). Included in the terms of contracts are the laws which subsist at the time and place of the making of the contract as if they were expressly incorporated into the terms. *Id.* at 888. The strength of every contract lies in the right of the promisee to rely upon the constitutional security against impairment of its obligations by legislation. *Board of Education v. City of Louisville, Ky.*, 157 S.W.2d 337 (1941).

The contractual promise under the master agreement is two-fold: first, the Master Agreement provides an “irrevocable pledge and guarantee” to pay post-secondary tuition, and second, the pledge and guarantee is supported by 75% of the abandoned property fund. If \$13.7 million is taken from the KAPT fund and placed into the General Fund the KAPT program will have an unfunded liability. Furthermore, if all future transfers from the KAPT reserve fund to the KAPT fund are prohibited, the only mechanism contemplated by statute and contract to cover an unfunded liability will not exist. These actions violate the express terms of the Master Agreement.

When the KAPT Board voted to transfer \$13.7 million from the reserve fund to the KAPT fund in December, 2004 it was acting under an explicit delegation of authority from the legislature. The Board had a duty to maintain a fund sufficient to *defray* its obligations. The mechanism the legislature provided to the board to meet this obligation was the abandoned property fund which the Board could use to meet any *unfunded liability as determined by the Board*. The Board had sole discretion to determine when an unfunded liability existed. Yet, the Board did not act arbitrarily when it made this determination. It obtained an actuarial analysis, as required by statute, considered and

debated the actuary's recommendation in open session, and then voted unanimously to make the transfer to meet KAPT's unfunded liability of \$13,700,051. (Deposition of Jo Carol Ellis, p 59, Exhibit 9.)

The U.S. Supreme Court addressed the deference to be accorded statutory interpretation by executive agencies where the legislative branch has expressly delegated authority to the agency to elucidate a specific provision in *Chevron, U.S.A., Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837, 843, 104 S. Ct. 2778, 2782, 81 L.Ed.2d 694 (1984). The Court explained that when reviewing an agency's construction of the statute which it administers, a court is confronted with two questions:

First, always, is the question whether Congress has directly spoken to the precise question at issue. If the intent of Congress is clear, that is the end of the matter; for the court, as well as the agency, must give effect to the unambiguously expressed intent of Congress. If, however, the court determines Congress has not directly addressed the precise question at issue, the court does not simply impose its own construction on the statute, as would be necessary in the absence of an administrative interpretation. Rather, if the statute is silent or ambiguous with respect to the specific issue, the question for the court is *whether the agency's answer is based on a permissible construction of the statute.* (Emphasis added).

It has long been recognized "that considerable weight should be accorded to an executive department's construction of a statutory scheme it is entrusted to administer [.]” *Id.* at 844, 104 S. Ct. at 2782.

The Kentucky Supreme Court and the Kentucky Court of Appeals have followed the standard of review articulated in *Chevron, supra*. *Board of Trustees of the Judicial Form Retirement System v. Attorney General of the Commonwealth of Kentucky*, 132 S.W.3d 770 (Ky., 2003); *Kreate v. Disabled American Veterans*, 33 S.W.3d 176 (Ky.App., 2000). In light of the deference mandated by these authorities, the narrow

question presented is whether the Board's interpretation of the provisions at issue is a "reasonable one." *Chevron, supra*, 467 U.S. at 845, 104 S. Ct. at 2783.

The legislation in question neither defines "unfunded liability" nor provides the Board a time frame for determining when the KAPT Fund must be able to "defray" its obligations. Hence the Board was left to use its best judgment. It did just that: it followed the advice of its actuary and pursued the least expensive and most responsible course from the perspective of both the Commonwealth and the citizens who had purchased KAPT contracts. By transferring the money, the Board found that "defray" meant presently capable of paying anticipated obligations and "unfunded liability" meant a liability which was not currently funded. The Board's decision was reasonable, and therefore deserves the deference of the Court.

Once the KAPT Board determined an "unfunded liability" existed which the KAPT Fund could not "defray", making a transfer sufficient to erase that liability became an obligation of the Board under KRS 164A.704(7) and under the KAPT contracts. When the transfers were made the KAPT Board was fulfilling its duty to the contract purchasers. Conversely, the contract owners had, and have, a contractual right to have that money placed in the KAPT Fund to defray its obligations to them.

Removing the \$13.7 million transferred into the KAPT Fund would increase the likelihood the Fund would default on its obligations in the future. Default is not a certainty. However, it does not have to be. Removing the money from the KAPT Fund will presently and materially affect the purchasers by increasing the risk of their investments. It will also divest them of an existing contractual right.

The same is plainly true if the KAPT Board is prohibited from using abandoned property funds as a reserve to guarantee the solvency of the KAPT Fund. The availability of the abandoned property fund is specifically pledged in the KAPT contract and by KRS 393.015, as it existed at the time the contracts were sold.

Therefore, the budget impairs the Commonwealth's obligation under the KAPT Contracts in violation of Section 19 of the Kentucky Constitution, both by taking money out of the KAPT Fund and by removing the abandoned property pledged as a guarantee of the obligations in the contract.

II. Taking \$13.7 million from the KAPT fund and placing it into the General Fund violates Sections 2, 13, and 51 of the Kentucky Constitution

The Commonwealth is vested with title to all property which is presumed to be abandoned, subject to "all legal and equitable demands." KRS 393.020. The Finance and Administration Cabinet has interpreted this to mean the escheated property becomes "public" property, as the term is defined by *Armstrong v. Collins*, 709 S.W.2d 437, 446 (Ky., 1986), and may be used by the General Fund for the operations of the Commonwealth so long as the liability to the owner of the property remains on the books. The Attorney General does not contest this interpretation in these proceedings although it is recognized that there is room for disagreement on the point.

The issue is whether the money in the KAPT Fund is "private", and if so, did the nature of the abandoned property funds placed in the KAPT Fund become "private funds". The General Assembly may "notwithstanding" existing statutes and appropriate public funds held in trust or in agency accounts within a budget bill. However, that authority does not extend to private funds which come under the authority of a state agency. Moreover, because the General Assembly has no authority to transfer private

funds to the General Fund, the transfer of money from agencies in which public and private funds are commingled, cannot be differentiated, and is unconstitutional. *Armstrong v. Collins*, *supra.*, at p. 446-447. In order to determine whether funds are private, and beyond the control of the General Assembly, it is “only necessary to identify” their purpose, nature, and source. *Thompson v. Kentucky Reinsurance Association*, 710 S.W.2d 854, 857 (Ky., 1986).

The facts of *Armstrong v. Collins*, *supra.* are analogous to the present case and worth review. In 1984 the General Assembly passed a biennial budget which, among other things, diverted funds from the Kentucky Employees Retirement System, County Employees Retirement System, State Police Retirement system, and the Teachers Retirement System. The Court held the General Assembly has the power through use of the budget bill to repeal or amend the manner in which public funds are used without violating *KY. Const. Sec. 51*, the “title” section, because such matters relate to appropriations. However, “because the General Assembly has no authority to transfer private funds to the general fund, the transfer of money from agencies in which public funds and private employee contributions are commingled, and cannot be differentiated, is unconstitutional.” Therefore, the appropriations from the retirement funds were set aside even though the state contributions to those funds could be calculated.

Like investments in employee retirement accounts, investments in the KAPT Fund are investments in the future of the purchaser and his or her family. The purpose of the money in the KAPT fund is to pay college tuition for the beneficiaries of the KAPT contracts; usually the children or grandchildren of the purchaser. The nature of the money is private investment to cover the future educational needs of those children and

grandchildren. The source is the private citizens of the Commonwealth of Kentucky. The investments bear no relationship to traditional state functions. Nor was it ever contemplated the money would go toward payment for anything other than college tuition. Hence, the logical and correct conclusion to be drawn is the KAPT Fund is private and is not subject to appropriation by the General Assembly through a budget bill, or otherwise.

The Finance and Administration Cabinet would like to confuse this legal analysis by taking a phrase from KRS 164A.701 (4) and article 8.02 of the Master Agreement out of context. The phrase is: “Assets of the fund shall constitute public funds of the Commonwealth...” Taken alone it appears relevant. Yet, when read in context it clearly is not. Article 8.02 reads as follows:

Article VIII, 8.02: Public Funds. Assets of the fund shall constitute public funds of the Commonwealth and may be invested in any instrument, obligation, security, or property which constitutes legal investments for the investment of public funds in the Commonwealth which are deemed most appropriate by the Board. The fund may be pooled for investment purposes with any other investment of the Commonwealth which is eligible for such pooling. Income earned from investment of the fund shall remain in the fund and shall be credited to KAPT.

KRS 164A.701 (4) is provided as it is found in HB 184 to allow a view of the pertinent part of the statute as it existed both before and after the amendment which took affect in July, 2005:

(4) (a) Assets of the fund shall ~~constitute public funds of the Commonwealth and may~~ be invested in any of the following~~[instrument, obligation,]~~ security types~~[-, or property that constitutes legal investments for the investment of public funds in the Commonwealth]~~ that are deemed ~~most~~ appropriate by the board:

In both the statute and the contractual clause, the statement concerning “public funds” is tied directly to the nature of investments to which the assets may be put. This opened up categories of investment which would not otherwise be available. On the other hand, they also severely limit the investments to those which would inure to the benefit of the KAPT Fund. Yet, the Finance and Administration Cabinet would have this Court find the mere use of the term “public funds” grants the legislature *carte blanche* to take assets from the fund and use for any purpose they see fit. The budget does not even pretend to invest the assets it takes for the benefit of the KAPT Fund. Obviously, such a result was not the intention of any party to the contracts.

Moreover, an interpretation of the law which would render the assets in the KAPT Fund subject to seizure by the General Assembly must logically lead to the conclusion the contracts are illusory, a result disfavored by the rules of construction for contractual interpretation. 17A Am. Jur.2d, *Contracts*, Section 377. If the KAPT Funds are found to be subject to seizure by the General Fund, the Commonwealth could take all the money in the KAPT fund causing it to default on all the contracts. The purchasers would have no right to complain because under the Respondent’s theory such was contemplated in Article 8.02 of the contract. This result is compelled by the fact that if any assets in the KAPT fund are “public” then all are “public”. There is no way to distinguish between the assets transferred from the reserve fund and those received from private investors. The moneys have long since been commingled. Hence, the theory is over inclusive and does not lead to the purported result, return of the \$13.7 million. The KAPT Fund cannot “return” the \$13.7 million it received last year, because the “public” and “private” funds cannot be differentiated.

That the clause in question was not intended to grant the legislature authority to seize KAPT assets is found in the amendments to KRS 164A.701 (4) which removes the “public” designation and simultaneously the option to place those assets in investments with other public funds. However, this is telling on a level beyond that of legislative intent. It reveals that a statutory designation of whether funds are “public” or “private” is meaningless within a constitutional analysis.

The Kentucky Constitution is the document which grants the General Assembly authority to appropriate, and therefore, it is the only source of authority which can define the limits of that power. Section 2 of the Kentucky Constitution provides:

Absolute and arbitrary power over the lives, liberty and property of freemen exists nowhere in a republic, not even in the largest majority.

Ky. Const. Section 2 relates to the exercise of arbitrary power over the lives, liberty and property of individuals, and not the handling of state property or funds. *Guthrie v. Curlin*, Ky., 263 S.W.2d 240, 244 (1953).

Section 13 of the Kentucky Constitution provides:

... nor shall any man’s property be taken or applied to public use without the consent of his representatives, and without just compensation.

And Section 51 of the Kentucky Constitution provides:

No law enacted by the General Assembly shall relate to more than one subject, and that shall be expressed in the title, and no law shall be revised, amended, or provisions thereof extended or conferred by reference to its title only, but so much thereof as is revised, amended, extended or conferred, shall be reenacted and published at length.

Any one of these Sections, and possibly all three, prohibits the appropriation of private funds to be put to public use. In *Guthrie v. Curlin, supra*, the court cited to

Section 2. In *Thompson v. Kentucky Reinsurance Association, supra*, section 51 is cited both for its holding and for the holding in *Armstrong v. Collins, supra*. See footnote 7, at p. 857.

The upshot is that there would be no check on the General Assembly's power to appropriate if the power to define "private" property also lies with the General Assembly. Any property could be designated as "public" by statute, and then taken. This is exactly the conduct sections 2 and 13 were intended to prohibit. Section 51 prohibits such action since private property cannot be appropriated and, therefore, such action could not be undertaken in an "appropriations bill".

The assets held within the KAPT fund are plainly private funds in which the contract purchasers and beneficiaries have a present and vested interest for analysis of the General Assembly's appropriation authority. As such, the provisions of the current budget which take money from the KAPT Fund and place it in the general Fund are unconstitutional.

CONCLUSION

The facts of this case are not in serious dispute. The language in the KAPT contract is plain and requires no parole evidence for explanation. The nature and purpose of the private investments the citizens of Kentucky have placed in the KAPT Fund are self evident. The reason for the transfer of public funds into the KAPT Fund is derived directly from the minutes of the December, 2004 KAPT Board meeting. Finally, the manner in which the transferred funds were commingled with the private investments in the KAPT Fund is established by the testimony of its account manager. Conversely, no evidence has been produced to counter the statements of Mr. Crompton, KAPT's actuary,

Mr. Long, the afore mentioned account manager, or Treasurer Miller and his staff, who have provided affidavits relating to the creation of the KAPT program as well as the nature of the abandoned property fund. This evidence is unrebutted, and cannot be rebutted. This leaves no material issue of fact for the Court to decide.

Moreover, the law is clear. The strength of every contract lies in the right of the promisee to rely upon the constitutional security against impairment of its obligations by legislation. In short, the General Assembly cannot pass legislation which impairs a contract. By passing a budget which both takes money from the KAPT Fund, the sole source which is obligated to fulfill the obligations in the KAPT contracts, and further by removing the assets those contracts pledge as security for that fund the General Assembly has violate this constitutional protection.

Further, the private property of the citizens of the Commonwealth may not be taken by their government without due process of law and fair compensation. Yet, by passing a budget which would take \$13.7 million from the pooled assets which by law, and by the terms of their contracts, are the only assets which may be used to pay the promised benefits, the General assembly has done just that. These acts will negatively their investments in an immediate and material manner. The purchasers will be compelled to bear a risk which is compounded by the simultaneous loss of the security pledged for those contracts. This is a risk most will not accept, forcing them to cancel their contracts and forfeit any increase in value which has accrued since it was purchased.

For all of the foregoing reasons there remains no issue of material fact and the Petitioner is entitle to judgment as a matter of law.

Respectfully submitted,

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CERTIFICATE OF SERVICE

This is to certify that true and correct copies of the foregoing were served by mailing same, postage prepaid, this ____ day of October, 2005, to the following:

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